Supreme Court, U.S.
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IN THE
Supreme Court of the United States
OCTOBER TERM, 1995

MACH-TECH, LTD. PARTNERSHIP and SERV-TECH, INC., Tax Matters Partner,
Petitioners,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition For Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

PETITION FOR A WRIT OF CERTIORARI

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69 pp

QUESTION PRESENTED FOR REVIEW

The question presented for review is whether the Fifth Circuit used the correct standard of control in determining if the requirements of Section 174 of the Internal Revenue Code were met. Section 174 allows a taxpayer to deduct research and experimental expenditures incurred by the taxpayer in connection with his trade or business. A taxpayer can meet the "connection to business" test even though the taxpayer did not produce or sell a product at the time the expenditures were incurred, if the taxpayer has "operational nexus" at any time to a trade or business utilizing the product of the research. *Snow v Commissioner*, 416 U.S. 500, 94 S.Ct. 1876 (1974), *rev'g.* 482 F.2d 1029 (6th Cir.) and 58 T.C. 585 (1972); *Harris v Commissioner*, 16 F.3d 75 (5th Cir. 1994), *aff'g.* 58 T.C.M. (CCH) 1441 (1990), supplemented by 99 T.C. 121 (1992).

In this case, the Partnership incurred research and experimental expenditures in the development of the Fast Clean System. Subsequently, the Partnership merged into a corporation which used the fruits of the Partnership's research in its trade or business. The Fifth Circuit determined that after such merger, the Partnership did not have sufficient "control" over the Fast Clean System to have "operational nexus" and allow the Section 174 deduction for the research and experimental expenditures. The Partnership requests the Supreme Court establish the standard of control needed to have "operational nexus".

PARTIES TO THE PROCEEDINGS

1. For the Petitioners:

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   Calvin, Martha
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   Krajicek, Richard W.
   Krajicek, Stephen
   Miller, Max
   Miller, Michael
   Randall, Edward III
   Stanley, Charles

2. For the Respondent:

   The Commissioner of Internal Revenue

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Petition For Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

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REFERENCE TO THE OPINION BELOW

The opinion of the Fifth Circuit was not formally reported, but has been published electronically as *Mach-Tech Ltd. Partnership v Commissioner of Internal Revenue,* 1995 U.S. App. Lexis 17112, and unofficially at 95-2 U.S.T.C. (CCH) P50,375, and 76 A.F.T.R.2d (P-H) 5439. The opinion is reproduced in Appendix A to this Petition.

The opinion of the Tax Court can be found at 67 T.C.M. (CCH) 2984 (1994), and is reproduced in Appendix B to this Petition.

GROUND FOR JURISDICTION

The judgement appealed from was rendered by the Fifth Circuit on June 16, 1995. The jurisdiction of this

Court to review the judgement is contained in 28 U.S.C. Section 1254(1).

RULE INVOLVED

This case involves 26 U.S.C. Section 174 (hereinafter referred to as Section 174), which provides (and so provided for the years at issue) in pertinent part as follows:

> (a) Treatment as Expenses-
>
> (1) In General-A taxpayer may treat research or experimental expenditures which are paid or incurred by him during the taxable year **in connection with his trade or business** as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction.[emphasis added]

STATEMENT OF THE CASE

In 1983, Mach-Tech, Ltd., a Texas limited partnership (the "Partnership"), was formed to research, develop, reduce to commercial use, and operate and/or license a fully enclosed mobile heat exchanger bundle cleaning system (the "Fast Clean System"). Used in hydro blast cleaning of oil and gas industry equipment, the Fast Clean System is today an integral part of the trade or business of a $200 million revenue company named Serv-Tech, Inc., a publicly trade corporation engaged in the oil refinery maintenance business ("Serv-Tech").

Serv-Tech was the general partner of the Partnership, and the principal limited partners were Richard W. Krajicek and Ed Randall. Krajicek was also a principal shareholder,

president and chairman of Serv-Tech. He was also the co-inventor of the Fast Clean System. Randall was an investment banker, friend and business acquaintance of Krajicek for over twenty years. Together, they had previously been in a similar business.

Upon formation, the Partnership entered into several agreements. Among them was a contract with an affiliate of Serv-Tech for the research and development of the Fast Clean System, and another was an option granted Serv-Tech to acquire the Fast Clean System under certain conditions in exchange for a royalty.

Research and development of the Fast Clean System proceeded and by 1985 a successful prototype had been developed. Serv-Tech then undertook the additional task of field testing. Pleased with the results of the field testing, Serv-Tech made the decision in the Fall, 1985 to attempt to acquire the Fast Clean System. Although Serv-Tech had the royalty option mentioned above, it chose not to exercise it. Instead, it made an all or nothing offer to each limited partner to acquire such limited partner's partnership interest in exchange for Serv-Tech stock; if successful effectively merging the Partnership into Serv-Tech.

Serv-Tech's offer was made through an Offering Memorandum prepared in compliance with state and federal securities laws. The offer was conditioned upon acceptance by all the limited partners. The Offering Memorandum described the choice for each limited partner as either merging with Serv-Tech or having the Partnership "go alone". The Offering Memorandum did not mention the royalty option. All limited partners accepted the offer, and the Partnership merged with Serv-Tech in early Summer, 1986.

Upon audit, the Commissioner of Internal Revenue disallowed the Partnership's claimed 1983 and 1985 deduction for research and experimental expenditures. The Commissioner's theory for disallowance was that the Fast Clean System was not used in connection with the Partnership's trade or business, and there had never been any realistic prospect that it would be so used.

Relevant to the issue presented to this Court, the Partnership contended in the Tax Court that it incurred the research and experimental expenditures in connection with its trade or business involving the Fast Clean System by virtue of its subsequent use by Serv-Tech. Such subsequent use by Serv-Tech, the Partnership contended, was to be "attributed" to the Partnership under the opinion of this Court in *Snow v. Commissioner*, 416 U.S. 500, 94 S. Ct. 1876 (1974), *rev'g.* 482 F.2d 1029 (6th Cir. 1972) and 58 T.C. 585 (1972). In *Snow*, this Court allowed the Section 174 deduction to the research and development partnership when the actual trade or business involving the technology developed by that partnership was conducted by a successor corporation which acquired the technology from the partnership in exchange for ownership in the corporation. Such a relationship to the entity actually engaging in the trade or business was held by the Supreme Court to be all that the "in connection with" language of Section 174 required.

The Commissioner, on the other hand, contended that the activities of Serv-Tech after the merger should not be attributed to the Partnership because the limited partners' interests in the Partnership were much greater than their interests in Serv-Tech after the merger. The Commissioner argued that *Snow* was not applicable because it involved a mere change in form of business enterprise with no change in ownership. This purported distinction - mere change in form versus change in percentage of ownership - is not

discussed in the *Snow* opinion nor even suggested as an issue.

The Tax Court agreed with the Commissioner on this newly developed ownership issue, and held that the Partnership was not entitled to its Section 174 deduction, citing as additional authority the Fifth Circuit's opinion of *Harris v. Commissioner*, 16 F3d 75 (5th Cir. 1994), *aff'g.* 58 T.C.M. (CCH) 1441 (1990), supplemented by 99 T.C. 121 (1992).[1] In *Harris*, the Fifth Circuit interpreted this Court's *Snow* opinion as leaving open the degree of connection required between the expenditures and the operation of the trade or business itself - the so called "operational nexus". *Harris* at 78. According to the Fifth Circuit, the one dispositive factor on whether there is operational nexus is whether "the **entity** that incurred the research expenses **actually managed** and **actually controlled** the use or marketing of the research results." *Harris* at 80 (emphasis added). As an example of a situation where the deduction was warranted, the Fifth Circuit cited with approval the decision of the Sixth Circuit in *Smith v. Commissioner*, 937 F.2d 1089 (6th Cir. 1991), *rev'g.* 91 T.C. 733 (1988). In *Smith*, the deduction was allowed even though it was found that the partnership at issue in that case would transfer its technology to a joint venture with a public utility (and thus not be the entity engaging in the trade or business), would suffer a substantial dilution of ownership of its developed technology incident to its transfer and use in a trade or business by such joint venture, and would not

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[1] Although not relevant to the issue being presented in this Petition, the Tax Court also found that there was no realistic prospect that the Partnership could ever engage in a trade or business utilizing the Fast Clean System.

likely control the ongoing business[2] The effect of the *Smith* opinion is to allow attribution, and thus establish operational nexus, regardless of the percentage of ownership or day to day control of the successor entity.

Encouraged by the Fifth Circuit's favorable comments regarding *Smith* and the similarity of the *Smith* facts to its case, the Partnership appealed the Tax Court's decision to the Fifth Circuit. Before the Fifth Circuit, the Partnership argued that the Tax Court's imposition of a substantial identity of ownership requirement in the successor entity (Serv-Tech) was an incorrect application of the law as enunciated by this Court in *Snow* and the Fifth Circuit in *Harris*. In support of its contention, the Partnership cited the Fifth Circuit's approval of *Smith* and compared its facts to those of both *Snow* and *Smith*, establishing almost complete factual identity.

In reply, the government countered the Partnership's challenge to the substantial identity of ownership requirement as a precondition to attribution by abandoning its mere change in form argument altogether. In its place, the government stated in footnote nine of its Brief that the issue of the degree of control had not been addressed by the Supreme Court in *Snow*. The government went on to argue that the Fifth Circuit had addressed "control" in *Harris*, and it meant continuing "day to day" control. Further, the government asserted that "Serv-Tech carefully structured the acquisition of the Partnership interests to ensure the original stockholders would remain in control." Appellee's Brief, p.36.n.9. In effect, the government's argument was that control had to result from ownership in Serv-Tech received in exchange for the Partnership interests. Pre-existing

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[2] In *Smith*, the partnership had not actually engaged in a trade or business, so its prospects for doing so was established by experts.

ownership of Serv-Tech by individual partners did not count. Under the government's theory, control, and thus operational nexus, requires no less than continual majority ownership, since the only way to achieve day to day control is to own at least 51%.

Subsequent to filing of the Partnership's Opening Fifth Circuit Brief and the government's Fifth Circuit Brief, the Ninth Circuit issued its opinion in *Scoggins v. Commissioner*, 46 F.3d 950 (9th Cir. 1995), *rev'g.* 61 T.C.M. (CCH) 2859 (1991). *Scoggins* allowed the Section 174 deduction to a partnership that was obligated to sell its technology to a corporation controlled by the members of the partnership pursuant to a pre-arranged contract. The Ninth Circuit thus attributed the control of the taxpayers as stockholders of the acquiring corporation to their control as partners of the selling partnership. Thus, through *Scoggins*. the Ninth Circuit did exactly the opposite of what the government was arguing for in this case.

Following the *Scoggins* opinion, the Fifth Circuit's approval of *Smith* and the controlling facts in *Snow*, the Partnership argued in its Reply Brief that the "control" referred to by the Fifth Circuit in *Harris* was "strategic" control over the direction of the commercialization of the technology and not continuing day to day control or continuing majority ownership, because such a requirement would emasculate Section 174 due to the economic impossibility of compliance.

On the issue here presented, The Fifth Circuit opinion in this case held that the Partnership, based upon its post merger ownership interest in Serv-Tech, "could not exercise the control over the exploitation of the technology as required by *Snow* and *Harris*." *Mach-Tech v Commissioner,*

1995 U.S. App. LEXIS 17112 at *8[3]. The Fifth Circuit thus rejected the Partnership's suggested legal standard of "strategic control" and accepted the government's interpretation of "continuing day to day control" or continuing majority ownership as the legal standard for measuring the control needed for operational nexus[4]. It determined whether the requisite control existed solely by reference to the stock received by the limited partners in exchange for their partnership interests. The Fifth Circuit did not attribute the existing ownership of certain of the partners of the Partnership in Serv-Tech in determining

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[3] In its Fifth Circuit Brief, the government argued that the moment for testing the deductibility was at the time the expense was incurred. In its Reply Brief, the Partnership refuted this contention and established that the case law looks to the facts existing at the time of trial since the operational nexus requirement can be satisfied **at any time**, not just at the time the deduction is claimed. *See,* Appellants' Reply Brief, 2-10. The Fifth Circuit agreed and rested its decision on the Partnership's lack of resulting control after the merger. *See, Mach-Tech v. Commissioner*, 1995 U.S. App. LEXIS 17112 at *1, 2. (" Courts have determined that a taxpayer can meet the 'connection to business test'...if a taxpayer is engaged in a trade or business at any time, and the deducted expenditures were incurred with respect to that business." [Emphasis added])

[4] Giving credit where it is due, we commend the Fifth Circuit for enunciating the "operational nexus" concept in *Harris*. It is in line with what the Supreme Court intended in *Snow*. It is unfortunate the Fifth Circuit deprived operational nexus of any legal significance by establishing an unrealistic standard of control in this case. The Fifth Circuit opinion establishes a required standard of control despite its attempt to classify its decision on this issue as a factual matter *see, Mach-Tech v Commissioner,* 1995 U.S. App. LEXIS 17112 at *8. Further, the Fifth Circuit's declaration that its opinion in this case has no precedential value and therefore should not be formally published is clearly erroneous. *Id,* at *1, n.1. The question of the degree of control required to meet the fifth Circuit's operational nexus is a legal one which the government acknowledged on Brief had not been previously addressed. Appellee's Brief, p. 36, n. 9.

whether the requisite control was present as was done in *Scoggins*, and it offered no explanation why the standard applied in *Scoggins* was not being applied in this case. In fact, the Fifth Circuit did not mention the *Scoggins* decision in any respect. It also did not discuss its prior approval of *Smith* nor distinguish it from this case. Finally, the Fifth Circuit completely ignored this case's factual and legal identity with *Snow*, simply stating that the Partnership was stretching the meaning of *Snow*.

REASONS FOR GRANTING THE WRIT

Review on Writ of Certiorari should be granted for the following reasons:

1. The decision of the Fifth Circuit in this case conflicts with the decision of this Court in *Snow*.

2. There is a conflict among the Fifth Circuit on one hand, and the Sixth and Ninth Circuits on the other, as to the standard of ownership and control an entity or its owners must have over the developed technology in order to be entitled to the Section 174 deduction.

3. The question of degree of "control" and "operational nexus" represents an important question of federal law which has not been, but should be, settled by this Court.

The reason for granting the writ is obvious. Both the Fifth Circuit and the government acknowledge this Court has not established the degree of continuing control, if any, a taxpayer must have over the technology it develops in order to obtain the Section 174 deduction. The lack of a standard has resulted in unequal treatment of the issue by the various Courts of Appeal. The resulting chaos creates conflict

among the circuit courts, and between them and this Court's opinion in *Snow*. As discussed below, this is an important question of federal law which impacts not only the taxing arena, but also other federal laws and initiatives.

I. The opinion of the Fifth Circuit in this case decides the control standard in a way that conflicts with this Court's *Snow* decision.

The country and the world in general is in the early stages of a technological revolution. To know this is true requires one only to look around. Advances in medicine, telecommunications, computer science and other areas are everywhere. Combined with the ever more complex global economy we live in, it becomes easy to see that in order for America to retain its pre-eminent position as economic leader with its attendant higher standard of living for its citizens, continued research and development of leading technologies is a must. Congress has long recognized this need and provided a subsidy in the form of the Section 174 deduction for research and experimental expenditures.

Development of new technologies will not be limited to existing companies; rather, it will be the entrepreneurs of tomorrow that will pioneer their development. After all, until a few years ago who heard of Microsoft Corporation. The same can be said of Apple Computer, Genentech [5]and a host of other companies that have sprung into existence and prominence on the strength of new technologies developed by their founders.

The Section 174 deduction figures prominently in this quest for new and better technologies by these and yet to be

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[5] None of these companies existed when this Court issued its *Snow* opinion.

heard of entrepreneurs. The Section 174 deduction may well be the deciding factor in whether a new technology should be researched and developed by a start-up company, which is usually nothing more at that point than one person's idea. Without the deduction, the cost of researching the new technology is probably prohibitive. Congress specifically recognized this probability when drafting Section 174, and this Court acknowledged it citing both the Hearings on HR 8300 before the Senate Committee on Finance, 83d Cong., 2d Sess, pt1, p.105, and 100 Cong. Rec. 3425 (1954), in *Snow v Commissioner*, 416 U.S. 500 at 503, 504:

> The legislative history makes fairly clear the reasons. Established firms with ongoing businesses had continuous programs of research quite unlike small or pioneering business enterprises. Mr. Reed of New York, Chairman of the House Committee on Ways and Means, made the point even more explicit when he addressed the House on the bill:
>
> "Present law contains no statutory provision for dealing expressly with the deduction of these expenses. The result has been confusion and uncertainty. Very often, under present law small businesses which are developing new products and do not have established research departments are not allowed to deduct these expenses despite the fact that their large and well-established competitors can obtain the deduction... This provision will greatly stimulate the search for new products and new inventions upon which the future economic and military strength of our Nation depends. *It will be particularly*

> *valuable to small and growing businesses.* [emphasis added by the Supreme Court]

This Court made the above passage the centerpiece of its *Snow* opinion, stating at 504:

> Congress may at times in its wisdom discriminate tax-wise between various kinds of businesses, between old and oncoming businesses and the like. But we would defeat congressional purpose somewhat to equalize the tax benefits of the ongoing companies and those that are upcoming and about to reach the market by perpetuating the discrimination created below and urged upon us here.

Snow, following congressional intent and economic logic, provides a liberal interpretation of the Section 174 trade or business requirement which the courts below had refused to follow. When *Snow* was rendered, taxpayers were looking to this Court to set the record straight, and it did so in a manner which was true to business realities, congressional intent, and the meaning of Section 174.

The Fifth Circuit opinion, from which this Writ is sought, ignores these business realities, congressional intent and the meaning of Section 174 by establishing a control standard contrary to the foregoing, and thus contrary to this Court's opinion in *Snow*. It is not a liberal interpretation, as is the strategic control standard argued for by the Partnership. Rather, it is a strict literal interpretation of the term "control" which, contrary to congressional intent, restricts, not broadens, the applicability of Section 174. The Fifth Circuit opinion in this case totally contradicts this Court's interpretation of the "in connection with" language of Section 174. *Snow* did not require a current trade or

business and attributed the activities of a successor to the predecessor for purposes of qualifying for the deduction. The effect of the current Fifth Circuit opinion is to make *Snow* an aberration to allowance of the Section 174 deduction, rather than the standard it should be as an opinion of this Court. Thus, this Court should grant this Writ to remove the "cloud" placed on *Snow* by the Fifth Circuit and to re-affirm the underlying principles for which *Snow* stands.

II. By denying business realities, the Fifth Circuit's opinion creates a conflict between it and the Sixth and Ninth Circuits.

At both the Tax Court and Fifth Circuit, the Partnership explained it defies all business reality to think the entity developing a product will continue to maintain the control mandated by the Fifth Circuit. Unlike the Fifth Circuit, the Sixth and Ninth Circuits' opinions of *Smith v Commissioner*, 937 F.2d 1089 (6th Cir. 1991), *rev'g.* 91 T.C. 733 (1988) and *Scoggins v Commissioner*, 46 F.3d 950 (9th Cir. 1995), *rev'g.* 61 T.C.M. (CCH) 2859 (1991) accept and incorporate business reality in their interpretation of Section 174. This Court likewise acknowledged business realities in its *Snow* opinion. In *Snow*, the development partnership ran out of money, and the development was completed with funds borrowed from the general partner. Thereafter, the technology was somehow transferred to a new corporation and the actual trade or business begun. "Somehow" is the correct description of the process because the *Snow* record does not disclose the terms of the transfer of the technology to the corporation. The Partnership argued on brief that business reality dictated that in *Snow* additional funds of some sort of funding would be needed to commence commercial operations and that whoever provided those funds did not do so gratuitously; that is, something was received in return. Consequently, the *Snow* partners had to

have owned less than 100% of the technology when commercialization began. What the *Snow* partners did have was the right to decide which of several avenues would be chosen for the commercialization of the developed technology. i.e. "strategic control."

Despite the Partnership repeatedly making this point, the lower courts failed to grasp this basic business reality, and in conflict with the Sixth's *Smith* and Ninth's *Scoggins* made their decision in a legal vacuum.

The conflict among the Circuits concerning the standard of "control" and thus operational nexus is as follows. The Fifth Circuit looks only to ownership in the developing entity and will not consider pre-existing ownership in the successor entity, while the Ninth Circuit does just the opposite and will consider pre-existing ownership in the successor entity, not just ownership received in exchange for ownership in the development entity. The Fifth Circuit requires the owners of the developing entity, **as a result of ownership of the developing entity**, to own a majority in interest in the successor entity so that they literally "control" the successor entity. The Ninth Circuit requires no equity ownership in the successor entity as a result of ownership in the development entity. In line with the Ninth Circuit is the Sixth Circuit which allows for substantial dilution of ownership from the development entity versus the successor entity and does not require the developing entity to be in continuing day to day control. These latter two Circuits have in essence adopted the strategic control approach argued for

by the Partnership in this case, and which makes more sense as explained below.[6]

Dilution of ownership and loss of "day to day control" is part of everyday life in the business community, particularly in the venture capital arena which is the heart of research and development. Thus, any interpretation of Section 174 that fails to grasp this reality is flawed and should not be allowed to stand. Evidence of this business reality is found everywhere from current real life situations to the classroom.

William A. Sahlman, Professor of Business Administration at the Harvard Business School[7] notes in his article, *The Structure and Governance of Venture-Capital Organizations*, Journal of Financial Economics 27 (1990) 473-521, North Holland, at 475:

> Venture capitalists invest at reasonable well defined stages... The seed stage typically precedes formation of a complete management team or completion of a product or service design. Each successive stage is generally tied to a significant development in the company, such as completion of design, pilot

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[6] For assistance in understanding the differences among the Circuits, attached hereto as Appendix C-1 through C-5 are diagrams of the pre and post technology transfer ownership structure presented in this case, *Snow*, *Smith* and *Scoggins* as well as a single diagram depicting all of the post technology transfer ownership for ease of comparison.

[7] At Harvard Business School, Dr. Sahlman teaches a course on Entrepreneurial Finance. His primary research interests are financial contracting and risk capital, with major emphasis on venture capital, initial public offerings, and leveraged buyouts.

> production, first profitability, introduction of a second product, or an initial public offering.

Reproduced as Appendix D is a detailed description of the stages of venture capital investing referred to by Dr. Sahlman in his article. Of particular relevance to the issue before this Court is Dr. Sahlman's definition of "seed investments" He defines the term as a **small** amount of capital provided to an inventor or entrepreneur to determine whether an idea deserves further consideration and **further investment.** If it is a technology, this stage may involve building a small prototype. **This stage does not involve production or sale.** *See*, Appendix D.

Dr. Sahlman's definition of "seed investment" fits the *Snow* partnership, the *Scoggins* partnership at issue before the Ninth circuit, the *Smith* partnership at issue before the Sixth Circuit, and most importantly the Mach-Tech partnership at issue in this case. As defined, the seed stage involves only a small investment and precedes formation of a complete management team; thus, a seed stage company lacks the financial wherewithal or the infrastructure to "control" the ultimate use or marketing of the research which the Fifth Circuit has required by its opinion in this case.

Dr. Sahlman goes on to note that the founders of many of these seed investments were often diluted in ownership well below 50% by the time the company made an initial public offering of its stock. Examples of ownership dilution of technology intensive companies mentioned at pages 485 and 486 of his article were the following:

Name of Company	Beginning Ownership	Ending Ownership (After Initial Public Offering)
Apple Computer	100%	30.7%
Cray Research	100%	24.3%
Genentech	100%	41.4%
Lotus Development	100%	30.9%
Seagate	100%	64.1%

In all the examples save one, the founders' ownership was diluted through the successive rounds of funding until it was substantially below 50%.

Genentech is a particularly interesting and relevant example. Founded in 1976 to explore the commercial possibilities of recombinant DNA, the first capital was produced from the funds of one of its founders, Robert Swanson. Several months later, outside funds were obtained in return for 25% of the company. This dilution process continued until the company went public in 1980, raising $38.5 million, at which time the founders' original ownership had been reduced to 41.4%. At that time, the company had not marketed a product, i.e., had not commenced its trade or business. Its first product was ready for the market in 1982; however, the cost of marketing the product was so substantial that it licensed the product to Eli Lilly, a major drug company. The reason for license at this stage was that the company needed funds to develop new products, estimated to run over $100 million per product, not to mention the eight to ten years to bring a new drug to the market. Genentech simply could not afford to do both even though public and well capitalized.[8]

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[8] For further discussion of Genentech, see William D. Bygrave and Jeffry A. Timmons, *Venture Capital at the Crossroads*, Harvard Business School Press (1992),p. and *Hoover's Company Profiles*, The Reference Press, Inc.(1994), *available electronically* on America Online, Personal

This enormous cost of developing new products is forcing a change in the manner in which research and development is being undertaken. Historically, research and development was funded into a single company which continued to sell additional ownership interests in itself to finance the different stages of development outlined by Dr. Sahlman with the ultimate goal being a public offering. However, Professors William D. Bygrave and Jeffry A. Timmons of Harvard Business School maintain in their book, *Venture Capital at the Crossroads*, that the future will see more and more seed stage companies (that is those companies according to Sahlman's description in Appendix that have neither the capital nor the management or other infrastructure in place to conduct commercial operations) built with the intent of merging with giant corporations, and additionally they predict that more and more mergers with strategic partners[9] -- exactly the course of action followed by the Partnership in this case and which the Fifth Circuit held was insufficient to qualify for the Section 174 deduction. Obviously, the Fifth Circuit decision flies squarely in the face of known and well recognized business practices and represents an impediment to continued research and development in this country because of the importance of the Section 174 deduction to such development.

Strategic control, on the other hand, fits nicely within the framework of accepted business practices as outlined above. At the same time, such interpretation of control maintains the integrity of Section 174 because it requires freedom of decision on the part of the persons or entities

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Finance, Section, Keyword Genentech. A 1990 Tufts University study found the average cost of developing new drug was $231 million. Bygrave and Timmons at 115.

[9]*See*, Bygrave and Timmons at p.292

undertaking the research and development. Freedom of decision is the essential element missing in all of the cases in which the Section 174 deduction was properly disallowed. Strategic control does not limit a taxpayer's freedom of decision. It lets the market place dictate the course of events and allows a small company to obtain the Section 174 deduction safe in the knowledge that at the proper time, it can choose the best avenue for exploitation of its technology, whether through a merger with a strategic partner as done in this case, through a strategic alliance as was found in the Sixth Circuit's *Smith* case, through an outright sale as was allowed in the Ninth Circuit's *Scoggins* case, or otherwise. In each of these cases, the pubic interest was served because the free market system allowed individuals to make choices for the best method of commercialization to everyone's benefit. In contrast, the majority ownership control standard adopted by the Fifth Circuit creates artificial limitations on a taxpayer's freedom of decision, and thus interferes with the free enterprise system.

The failure of the Fifth Circuit to take into account business reality in applying Section 174 creates a conflict with the reality based approaches of the Sixth and Ninth Circuits. This conflict results in a lack of uniformity in application of this most important statute. Thus, this Court should grant this Writ to resolve the conflict.

III. The standard of control to be used is an important question of federal law.

A. It impacts many business and governmental economic initiatives.

As both the Fifth Circuit and the government have acknowledged, the question of the degree of control has not been addressed by this Court. The government argued however that the question of the degree of control had been resolved by the Fifth Circuit in *Harris v Commissioner*, 16 F.3d 75 (5th Cir. 1994). *See,* Appellee's Brief, p.36, n.9. Agreeing with the government, the Fifth Circuit held that the issue of control in this case was factual, not a legal issue. *Mach-Tech v Commissioner,* 1995 U.S. App. LEXIS, 17112 at *8. However, a closer look at *Harris* reveals that it only established "control" as the essential element of operational nexus; it did not establish the standard of control test needed to evaluate any particular circumstance. The Fifth Circuit decided this issue in this case solely by reference to the Mach-Tech partners' resulting post merger ownership interest in Serv-Tech, thereby adopting a literal interpretation of control--51%. This standard of control represents an important question of federal law which should be settled by this Court.

If this Court refuses to grant this Writ, the erroneous standard of control adopted by the Fifth Circuit will stand. To assist in understanding the importance of this Court establishing a correct standard of control, the computer software industry is examined below. The computer software example is given to allow this Court to contemplate how a taxpayer seeking to develop a new software product would fare under the present Fifth Circuit standard. The industry source information set forth below was taken from *Hoover Industry and Company Profiles*, The Reference

Press, Inc. (1994), *available electronically* on America Online, Personal Finance Section, Keyword Computer Software.

The computer software industry is worldwide in scope. For the latest year shown in the Hoover Industry Profile, worldwide revenue was almost $72 billion. The United States is the largest single market, followed by Japan, Germany, the United Kingdom and France. The top suppliers of software in 1992 were household names, IBM and Microsoft Corporation of the United States and Fujitsu and NEC of Japan.

Governments are participating in this industry in order to enable their economies to remain competitive. In Western Europe, for example, governments there have undertaken several long-term research and development projects. Among them is the Eureka Software Factory. Created in 1986, it is a 10 year software engineering project with a budget of $500 million. Its participating members include most of the countries of Western Europe, including Germany, France, Norway, Spain, Sweden, and the United Kingdom.

Private industry is also at work in Western Europe. In 1993, 15 European manufacturers formed an alliance known as the European Software Institute. Its nonprofit purpose is to promote and train European companies in software development techniques.

Things have been just as active in this country, and obviously need to continue if this country is to retain its current dominance in this area. At the federal level, Congress enacted the Stevenson-Wydler Technology

Innovation Act of 1980. 15 U.S.C. Section 3701 et. seq. In its current form, one of its declared purposes is to promote technology development through the establishment of "cooperative research centers." 15 U.S.C. Section 3702(2). The objective of the centers is to enhance technological innovation through, among other ways, the participation of individuals from industry and universities in cooperative technological innovation "activities," and the development of continuing financial support from other mission agencies, from state and local government, and from industry and universities through, among other means, fee licenses, and royalties. Its "activities" include, among others, assistance to individuals and small businesses in the generation, evaluation, and development of technological ideas supportive of industrial innovation and new business ventures. 15 U.S.C. Section 3705.

In addition, the Clinton administration, in order to maintain the competitiveness of U.S. high technology firms, plans to create a national "information superhighway," known as the National Information Infrastructure. The plan is to create an alliance between government and industry in which the private sector builds, operates and improves the infrastructure, and government creates an efficient, legal and regulatory environment and funds specific interconnection projects.

Private industry in this country is forming new alliances to develop new technologies. Among the more notable is Taligent, IBM's and Apple Computer's joint venture to develop the next generation of computer software operating systems employing an object oriented system. These companies are not alone. Intel, the leading chip manufacturer, and Microsoft have announced plans to form

an alliance to develop Windows Telephony, a software program that will make it easier for computers to work with telephone equipment.

Multimedia is another emerging market. Multimedia is the name given to computer software programs designed to combine video, animation, still pictures, voice music, graphics and text into a single system, blurring the lines between several formerly distinct industries. Strategic alliance dominate this area because these alliances reduce risks, spread costs, and allow companies to acquire expertise quickly. The alliances all involve well know American and multinational companies such as Time Warner and U.S. West; IBM, NBC television and NuMedia Corp.; IBM, Apple Computer and Toshiba; and Microsoft Corporation, Intel and General Instruments. These strategic alliances are the future of research and development as predicted to come into existence by Bygrave and Timmons in 1992 in their book.

Given that the computer software industry example can be applied today to all segments of industry, can any one taxpayer maintain actual -- 51% -- control from the birth of an idea through to its production and marketing? Obviously no! Yet, that is the "control" standard adopted by the Fifth Circuit. Such a standard will deter tomorrow's entrepreneurs and "seed investors" from pursuing the research and development vitally important to our economy. The Section 174 deduction was enacted to encourage these "seed stage investments." Under the Fifth Circuit' standard of control, the economic reality is that it is impossible for these entrepreneurs and "seed investors" to obtain the Section 174 deduction. The likely result will be less technology developed by the very people Congress sought to encourage with

Section 174, the entrepreneurs and small businesses. In effect, Section 174 will be void of its intended substance. Accordingly, the question of the degree of control necessary to establish operational nexus is far too important an issue of federal law to be left to the lower courts and instead should be decided by this Court.

B. An adverse standard of control causes serious damage to anti-trust laws and concepts.

The burden being imposed by the Fifth Circuit in its interpretation of Section 174 also does serious damage to the companion anti-trust laws and hinders the type of development envisioned by Congress and spoken of so eloquently by Mr. Reed. Under the Fifth Circuit's interpretation, the cost to develop new product and obtain the deduction becomes too much for small companies to bear. The result will be to create monopolies by default -- exactly the opposite of what Section 174 was intended to accomplish -- due to lack of competition, not from unreasonable restraints by an industry leader, but from the economic restraints of trying to compete without the benefit of the Section 174 deduction. Competition is the heart of America's free market, free enterprise system, and fostering competition is the core public policy of both Section 174 and companion laws. The Fifth Circuit's decision imposes artificial non free market barriers stifling competition and placing Section 174 at odds with other laws. Accordingly, the threshold control requirement of Section 174 is too important an issue of federal law to be decided by the lower courts. The standard should be established by this Court.

CONCLUSION

Petitioners request the Supreme Court to issue a Writ of Certiorari to the Court of Appeals for the Fifth Circuit to review the issues presented in this case.

Respectfully Submitted,

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APPENDIX A

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 94-40798

MACH-TECH, LTD. PARTNERSHIP
and SERV-TECH, INC.,
Petitioners-Appellants,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Appeal from the Tax Court of the United States
(6529-92)

Before JOLLY and BARKSDALE, Circuit Judges, and FELDMAN*, District Judge.

E. GRADY JOLLY, Circuit Judge:**

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*District Judge, of the Eastern District of Louisiana, sitting by designation.

**Local Rule 47.5 provides: "The publication of opinions that have no precedential value and merely decide particular cases on the basis of well-settled principles of law imposes needless expense on the public and burdens on the legal profession." Pursuant to that Rule, the court has determined that this opinion should not be published.

Serv-Tech, Inc. ("Serv-Tech"), the tax matters partner for Mach-Tech, Ltd. Partnership ("Mach-Tech"), appeals the Tax Court's disallowance of Mach-Tech's deduction for research and development expenses under 26 U.S.C. § 174 for the years 1983 and 1985. Because we hold that Mach-Tech neither was engaged in a trade or business, nor had a realistic prospect of engaging in a trade or business during the years at issue, we affirm the Tax Court's ruling.

I

The Internal Revenue Code, 26 U.S.C. § 174, provides that "a taxpayer may treat research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction." 26 U.S.C. § 174(a)(1). The costs represent "research and development costs in the experimental or laboratory sense." 26 C.F.R. § 1.174-2(a)(1).

A small body of case law has developed interpreting § 174. Courts have determined that a taxpayer can meet the "connection to business" test even though the taxpayer did not produce or sell a product at the time the expenditures were incurred, if the taxpayer is engaged in trade or business at any time and the deducted expenditures were incurred with respect to that business. *Snow v. Commissioner*, 416 U.S. 500, 94 S.Ct. 1876 (1974). Furthermore, a deduction under § 174 also may be allowed if it is determined that there was a "realistic prospect" that the technology developed will or would have been exploited in the taxpayer's trade or business. *See Zink v. United States*, 929 F.2d 1015, 1022-23 (5th Cir. 1991); *Diamond v. Commissioner*, 930 F.2d 372, 375 (4th Cir. 1991). The courts have closely scrutinized claimed research and development expenditures, particularly

those claimed by partnerships, to separate those that are legitimate from those that are merely designed to shelter the income of passive investors. *See, e.g., Harris v. Commissioner*, 16 F.3d 75, 80-82 (5th Cir. 1994).

We employ a *de novo* standard of review in examining the Tax Court's legal conclusions, including its interpretations of the Internal Revenue Code. *Harris*, 16 F.3d at 81. We must, however, accept the Tax Court's findings of fact unless they are clearly erroneous. *Id.* In this appeal, the question is whether the Tax Court was clearly erroneous in finding that in 1983 and 1985 there was no realistic prospect that Mach-Tech could use the technology it had developed in connection with its trade or business.

II

After considering the record, briefs, and arguments, we have reached the conclusion that the *Harris* analysis controls this case. Accordingly, we find that the Tax Court was not clearly erroneous in its findings of fact, nor did it commit reversible error in its legal reasoning. Our basis for reaching this result is outlined below.

A

We first undertake Serv-Tech's challenges to the Tax Court's findings of fact. Serv-Tech first argues that the Tax Court erred in determining that Mach-Tech was not engaged in a trade or business during the years at issue. Second, Serv-Tech contends that the Tax Court erred in determining that there was no "realistic prospect" that Mach-Tech would engage in a trade or business relating to the cleaning system. Despite Serv-Tech's arguments to the contrary, we are persuaded that when the Tax Court examined the "economic

realities of the financial arrangement" in this case, it could reach only the conclusion of nondeductibility. *See*, *Harris*, 16 F.3d at 79.

With respect to whether Mach-Tech was engaged in a trade or business, the capital contributed by the partners upon the formation of Mach-Tech was immediately funneled to a research and development company, which was a subsidiary of Serv-Tech. During the years in question, Mach-Tech had no employees. Furthermore, it is not even clear that Richard Krajicek, a major partner in Mach-Tech, co-inventor of the technology, and president of Serv-Tech, was acting on behalf of the partnership of Mach-Tech in his business activities for the years in question, 1983 and 1985. Considering these and other relevant facts reflected in its thorough opinion, the Tax Court did not err in its determination that Mach-Tech was not engaged in a trade or business during 1983 and 1985.

Furthermore, the Tax Court was not clearly erroneous in its finding that there was no "realistic prospect" that Mach-Tech would engage in a trade or business relating to the cleaning system. The existence of Serv-Tech's right of first refusal option, as well as the non-existence of a business plan in the event that Serv-Tech did not exercise its option, also serve to convince us that the Tax Court was correct in its findings. Still further, the record is not convincing that the partners, without Serv-Tech, realistically could have marketed the product. Thus, the Tax Court did not clearly err when it found that Mach-Tech was not involved in a trade or business, that it did not have a "realistic prospect" of engaging in one, and that the evidence demonstrated that the research and development indeed would be exploited through *another's* business.

B

We next turn to Serv-Tech's argument that the Tax Court committed legal error by misinterpreting *Snow v. Commissioner*, 416 U.S. 500 (1974). Serv-Tech argues that the Tax Court erroneously imposed an additional restriction on Mach-Tech by mandating that the partnership itself exploit the technology in order to meet the requirements of § 174. The Mach-Tech partnership sold their partnership interests to Serv-Tech for 7.5% interest in Serv-Tech, which marketed the technology. As was suggested at oral argument, Serv-Tech's argument stretches the meaning and intent of *Snow*, while refusing to recognize the significance of *Harris*. In *Snow*, which allowed the deduction under § 174, the partnership that conducted the research and development eventually incorporated so that it could market and exploit the technology. Serv-Tech analogizes its situation to that in *Snow*: Acknowledging that Mach-Tech's partners have only 7.5% interest in Serv-Tech that they received when they sold their partnership interests (and, thus, the technology) to Serv-Tech, they argue that because the actions of Serv-Tech on behalf of the product can be attributed to the former partners of Mach-Tech, they are entitled to the deduction. This argument ignores *Harris's* requirement of an "operational nexus"; that is, "the degree of 'connection' required between the expenditures and the operation of the trade or business itself." *Harris*, 16 F.3d at 78. In *Harris's* broad spectrum of financial arrangements," Mach-Tech's relationship with Serv-Tech falls toward the end of the spectrum of financial arrangements that function merely as "investment vehicle[s] that cannot deduct the cash paid to the corporation under section 174 even if the corporation used that very cash to fund its research expenditures." *Id.* According to *Harris*, a dispositive factor in cases determining whether a § 174 deduction is warranted is whether "the entity that incurred the research expenses actually managed and actually

controlled the use or marketing of the research results." *Id.* at 80. Despite Serv-Tech's "attribution" arguments, it is clear that the Tax Court did not err in finding that Mach-Tech, with its 7.5% interest in Serv-Tech after the merger, could not exercise the control over the exploitation of the technology as required by *Snow* and *Harris*. Thus, even though Serv-Tech characterizes this aspect of their appeal as a legal issue, it was a determination of fact by the Tax Court, which we do not find to be clearly erroneous.

III

In sum, the Tax Court was not clearly erroneous in finding that Mach-Tech was not engaged in a trade or business, and that it did not have a realistic prospect of engaging in a trade or business during the years of 1983 and 1985. Furthermore, we find that the Tax Court did not err in its determination that Mach-Tech did not maintain the requisite control over the technology after the merger to entitle it to the deduction under § 174. For the foregoing reasons, the judgement of the Tax Court is

AFFIRMED.

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 94-40798

MACH-TECH, LTD. PARTNERSHIP and
SERV-TECH, INC.,

Petitioners-Appellants,

versus

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appeal from Decision of the
United States Tax Court

Before JOLLY, and BARKSDALE, Circuit Judges, and FELDMAN*, District Judge.

BY THE COURT:

IT IS ORDERED that appellant's motion for judicial notice and use of substituted copy of expert report is DENIED.

/s/ E. GRADY JOLLY

U. S. District Judge

*District Judge, of the Eastern District of Louisiana, sitting by designation.

APPENDIX B

T.C. Memo. 1994-225

UNITED STATES TAX COURT

MACH-TECH, LTD. PARTNERSHIP, SERV-TECH, INC., TAX MATTERS PARTNER, Petitioner *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 6529-92. Filed May 23, 1994.

Larry E. Jacobs and *Ruth E. Salek*, for petitioner.

David B. Mora, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

FAY, *Judge*: As stipulated, the only issue for consideration is whether, pursuant to section 174,[1] Mach-Tech, Ltd. Partnership (Partnership) is "entitled * * * to elect to deduct its research and experimental expenditures."

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulations of fact and attached exhibits are incorporated herein by reference.

From December 1983 through June 1986, Partnership was a limited partnership formed under the laws of the State of Texas. When the petition was filed, Partnership no longer

[1]All section references are to the Internal Revenue Code in effect for the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, unless otherwise indicated.

had a principal place of business, but the principal place of business of its general partner and tax matters partner,[2] Serv-Tech, Inc.[3] (Serv-Tech), was in Houston, Texas.[4]

Serv-Tech is a corporation incorporated under the laws of the State of Texas. As of 1983, the business of Serv-Tech was industrial and chemical cleaning, plant maintenance, and oilfield services.

Partnership was formed to engage in the research, development, reduction to commercial use, and operation and/or licensing of a fully enclosed mobile heat exchange bundle cleaning system (the Fast Clean System), used in hydroblast cleaning of equipment used in the oil and gas industry.

Limited partnership interests in Partnership were acquired pursuant to a private offering memorandum dated December 8, 1983 (the 1983 memorandum). The limited partners in Partnership were as follows:

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[2]The term "tax matters partner" is defined in sec. 6231(a)(7).

[3]Serv-Tech, Inc. (Serv-Tech), was originally named Mac-Services, Inc., but its name was changed in 1984. For simplicity, all references herein are to Serv-Tech.

[4]Unless stipulated to the contrary, venue for appeal in petitions filed under the TEFRA unified partnership provisions is the U.S. Court of Appeals for the circuit in which the principal place of business of the partnership is located at the time the petition is filed. Sec. 7482(b)(1)(E); see *Peat Oil & Gas Associates v. Commissioner*, T.C. Memo. 1993-130, in which one of the factors we considered in deciding appropriate venue for appeal was the principal place of business of the tax matters partner.

Name	*Ownership Interest*
Richard W. Krajicek (Richard Krajicek)	29.7 %
Edward Randall, III (Mr. Randall)	39.6
Max Miller	4.95
Michael Miller	4.95
Martha Calvin	4.95
Michael Krajicek	4.95
Stephen Krajicek	4.95
Charles Stanley	4.95

From at least December 1983 through at least June 1986, Richard Krajicek, the co-inventor of the Fast Clean System, was also president, chairman of the board of directors, and a shareholder holding 34 to 40.5 percent of the stock[5] of Serv-Tech. Mr. Randall was an investment banker who had known Richard Krajicek for over 20 years and been involved with him regarding Cesco, a company engaged in the chemical plant cleaning business. As of May 12, 1986, Mr. Randall, Max Miller, Michael Miller, and Charles Stanley each owned less than 2 percent of the Serv-Tech stock.

On December 29, 1983, Partnership executed a research and development agreement (the form of which was attached as an exhibit to the 1983 memorandum) with Mac-Tech, Inc. (Mach-Tech), a wholly owned subsidiary of Serv-Tech. The research and development agreement provided that Mach-Tech, through its own activities and subcontracts, would use its best efforts to develop the technology and equipment for the Fast Clean System and assist in obtaining

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[5]From Jan. 1, 1983, through June 30, 1986, no other single shareholder owned more Serv-Tech stock than Richard W. Krajicek (Richard Krajicek).

patents therefor for a fixed fee of $347,500, payable $250,000 on or before December 31, 1983, and $97,500 during 1984. The research and development agreement terminated on the earliest of (1) reduction of the Fast Clean System to commercial use, (2) expenditure of the $347,500, or (3) December 31, 1985. Partnership paid Mach-Tech $250,000 on December 31, 1983, and $118,713 in 1985.[6]

Also on December 29, 1983, Partnership executed a grant of option to acquire exclusive license (license option agreement) with Serv-Tech, which granted Serv-Tech a right of first refusal to acquire a nonexclusive license and an exclusive license. Under this agreement, the form of which was also attached to the 1983 memorandum, Partnership could not "sell, alienate, assign or otherwise transfer any right, title, interest or license" to the Fast Clean System without offering Serv-Tech the option under the two license provisions.

The nonexclusive license option provided Serv-Tech with the right to manufacture and use the Fast Clean System in Serv-Tech's service operations for the 18-month period after the Fast Clean System was reduced to commercial practice.[7] If Serv-Tech exercised this option, Serv-Tech was

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[6]The parties stipulated that: "The Partnership has substantiated, all of its expenditures". There is no explicit explanation in the record for why the second amount was not paid in 1984, or was greater than the $97,500 provided in the research and development agreement. However, the research and development agreement states that Mach-Tech, Ltd. Partnership (Partnership) shall pay or reimburse Mach-Tech, Inc. (Mach-Tech), for certain costs relating to obtaining patents.

[7]The license option agreement defines the term "reduction to commercial practice" as the design and manufacture of a fully enclosed mobile bundle cleaning system and a successful bundle cleaning operation under normal commercial conditions, evidenced by a letter or other

required to "purchase" the Fast Clean System from Partnership for the greater of (1) the cost of reproduction reduced by depreciation, if any, or (2) the fair market value. At the end of the 18-month license term, if Serv-Tech did not exercise the exclusive license option described below, Partnership was required to repurchase the Fast Clean System for the greater of (1) the price paid by Serv-Tech, reduced by depreciation for tax purposes, or (2) fair market value.

The exclusive license option granted Serv-Tech the right to acquire an exclusive license "to manufacture, use, market and otherwise commercially exploit" the Fast Clean System for the period subsequent to the 18-month period. Except in the event of failure by Serv-Tech to pay royalties or make reasonable marketing efforts, this exclusive license would continue until the expiration, including extensions, reissues, or renewals, of any United States or foreign patents of the Fast Clean System or improvements thereon.

If Serv-Tech exercised either option, Serv-Tech agreed to pay Partnership a royalty of 12.5 percent for 1984 and 1985, and 2 percent thereafter, of gross revenues from (1) sales and rentals of machines utilizing the Fast Clean System, (2) sublicensing of the Fast Clean System, and (3) services using the Fast Clean System.

The unsigned certificate and agreement of limited partnership of Partnership (the partnership agreement) attached to the 1983 memorandum includes an option, exercisable in 1985 through 1987, for Serv-Tech to exchange its stock for all of the interests of the limited partners, provided that for the 90 days preceding the notice to exercise

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written instrument indicating satisfactory operation by the responsible manager of the industrial facility where such bundles were cleaned.

the option the Serv-Tech stock was listed on the New York or American Stock Exchange or quoted on the NASDAQ System.

The "Summary of the Business" section of the 1983 memorandum states in part: "The Partnership also will seek to secure patent protection for * * * [The Fast Clean System], and will grant to * * * [Serv-Tech], the General Partner, an option to acquire an exclusive license to commercially exploit * * * [the Fast Clean System]." The "FEDERAL INCOME TAX ASPECTS" section of the 1983 memorandum states in part: "* * *[Serv-Tech] will acquire * * * [the Fast Clean System], once developed, instead of the Partnership retaining it for use in its own trade or business". All of the "Financial Illustrations" in the 1983 memorandum assume that Partnership revenues from the Fast Clean System are 12.5-percent royalties for 1984 and 1985 and 2-percent royalties thereafter.

On February 15, 1985, Mach-Tech, acting as research and development contractor to Partnership, and Serv-Tech executed a testing agreement, pursuant to which Serv-Tech agreed to test the Fast Clean System in commercial jobs at its expense and was entitled to all revenues. The testing agreement did not provide for the sale of the Fast Clean System by Serv-Tech. The testing agreement terminated when the Fast Clean System was reduced to "optimum expected commercial use", but no later than December 31, 1985.

During 1985, Serv-Tech sold four units of the Fast Clean System to (1) Fast Clean, Inc., from which it leased them back for a rental "incurred" of about $30,000 for 1985, and (2) Nolo Bido, Inc., from which it received $48,883 for managing and operating the related equipment for 1985. In a report for the calendar year 1985, Serv-Tech stated that

five units of the Fast Clean System were in service during 1985 generating gross revenue of $985,105. Additionally, the notes to the consolidated financial statements for Serv-Tech and its subsidiaries for 1985 and 1986 state that the sales of the four units of the Fast Clean System "resulted in revenues of approximately $1,100,000 and manufacturing costs of approximately $834,000." No part of the proceeds from the sale of the Fast Clean System units nor royalties on the revenues generated from operation of it by Serv-Tech were paid to Partnership.

On September 9, 1985, an application for a United States patent for the Fast Clean System was filed,[8] and the patent was subsequently issued. On November 11, 1985, an application for a European patent for the Fast Clean System was filed on behalf of Partnership, and that patent was also subsequently issued.

The Fast Clean System was ready for commercial exploitation on January 1, 1986. On January 2, 1986, pursuant to the license option agreement, Serv-Tech executed a temporary nonexclusive license agreement with Partnership for the Fast Clean System for a period of 18 months, and Serv-Tech agreed to purchase the Fast Clean System equipment owned by Partnership for $121,208, payable with a note.

A document entitled "ASSIGNMENT" dated February 21, 1986, provides that Richard Krajicek and Robert R. Cradeur, as the joint inventors, assign Partnership all rights,

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[8]The patent document in the record describes the product as a "Mobile Articulatable Tube Bundle Cleaner", and reflects Serv-Tech as the assignee from the inventors, Richard Krajicek and Robert R. Cradeur. A confidential offering memorandum circulated in May 1986 (described *infra*) states that Mach-Tech applied for patents on behalf of Partnership.

title, and interest in the Fast Clean System and any related U.S. and foreign Letters Patent granted.

In May 1986, a confidential offering memorandum (the 1986 memorandum) pursuant to which Serv-Tech offered to exchange shares of its common stock for the interests of all of the limited partners in Partnership, was circulated to the partners of Partnership.[9] The 1986 memorandum stated in part:

> *Reason for Exchange Offer.* * * * [Partnership] was established to research, develop and test the Fast Clean system as to its feasibility and applicability in refinery, petrochemical and industrial applications. The general research objectives of * * * [Partnership] have been met. * * * [Mach-Tech], the research and development contractor, completed the research and development program at the end of December, 1985.
>
> In order to commercially exploit the developments made through the research and development program, it will be necessary to build additional Fast Clean systems, to expand marketing program [sic] and to coordinate the Fast Clean system with other petrochemical plant maintenance activities. * * * [Partnership] does not presently have the financial resources or the skilled personnel necessary to undertake such a program.
>
> * * * [Serv-Tech] feels that combined with * * * [Serv-Tech's] other product lines, the acquisition

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[9]The condition to the exercise of the option to exchange contained in the partnership agreement (that Serv-Tech stock be listed or quoted on one of the enumerated stock exchanges) was not met at that time.

> of * * * [Partnership] Interests will give * * * [Serv-Tech] the technology necessary to provide the petrochemical industry a totally integrated on-site heat exchanger maintenance capability. * * * [Serv-Tech's] presence in the market will provide the basis for introducing the Fast Clean system to its established customers. * * * [Serv-Tech] feels that it is positioned to undertake commercial exploitation of the Fast Clean system. *It is unlikely that * * * [Partnership] could economically provide for its own account, the experienced personnel, facilities and other resources which will be necessary to market and continue development of the Fast Clean system.* [Emphasis added.]

Pursuant to the 1986 memorandum, the exchange would only be consummated if all partners accepted. The number of shares to be exchanged was determined by the board of directors of Serv-Tech.[10] The 1986 memorandum stated further:

> *Control.* Assuming all of the Serv-Tech stock offered hereby is acquired pursuant to the terms of this Offering, the present shareholders of * * * [Serv-Tech] will own 92.3% of the shares of the Serv-Tech stock. Since * * * [Serv-Tech's] Articles of Incorporation do not provide for cumulative voting, such ownership and their positions with * * * [Serv-Tech] will enable such shareholders to continue to control * * * [Serv-Tech's] policies and affairs. * * *

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[10]The parties stipulated that the adequacy of the consideration in the exchange is not disputed.

Additionally, the 1986 memorandum provided that, "Concurrent with the offer to exchange" the stock, Serv-Tech requested that the limited partners of Partnership consent to the 1985 sales of the Fast Clean System, which it stated were sold to affiliates of Partnership at cost.

All of the limited partners in Partnership accepted the offer. In June 1986, the limited partners of Partnership received a total of 475,000 shares of Serv-Tech common stock in exchange for their partnership interests.

Thereafter, Serv-Tech used the Fast Clean System in its business. For the fiscal year ended December 31, 1992, Serv-Tech reported gross revenues of about $148 million and had net income of about $6 million. Regarding the 1986 exchange, the notes to the consolidated financial statements for Serv-Tech and its subsidiaries for the fiscal year 1985 state that, because of the exchange, Serv-Tech was "relieved of obligation to reimburse * * * [Partnership] for the research and development advances of $250,000" and that that amount would be recorded as income for the fiscal year 1986.

During the tax years 1983 and 1986, Partnership had no employees, no activities other than those described herein, and no office other than that of its general partner, Serv-Tech.

On the Form 1065, U.S. Partnership Return of Income for the short taxable year December 30 through December 31, 1983, Partnership elected to use the cash method of accounting and the current expense method for reporting "research and experimental expenses" under section 174(a), and deducted $250,000 for research and development expenses. An amended return was filed for that year to reflect a tax preference item of $247,917 for research and

development expenses.

On the return for Partnership for 1985, research and development expenses deducted total $118,713, and the tax preference item for research and development expenses is $106,842.

In Notices of Final Partnership Administrative Adjustment (FPAAs) for Partnership, respondent disallowed the "Research & Development" deduction claimed, and eliminated the tax preference item reported, for research and development expenses for each of the years 1983 and 1985, respectively.

OPINION

Section 174 allows a taxpayer to treat as deductible research and experimental expenditures paid during the taxable year "in connection with" the taxpayer's trade or business.[11] Treasury regulations provide that the expenditures may be paid for research or experimentation carried on by the taxpayer or another on the taxpayer's behalf. Sec. 1.174-2(a)(2), Income Tax Regs. The issue in this case is whether Partnership engaged in the requisite trade or business to which the expenditures in question relate.

Petitioner contends first that Partnership engaged in a trade or business by virtue of the operation of the Fast Clean System by Serv-Tech after the "merger" of Partnership with it. Second, petitioner argues that Partnership engaged in a trade or business based on the marketing activities during 1985 and 1986 of Richard Krajicek, who was allegedly acting as a limited partner of Partnership and

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[11]The "taxpayer" for this purpose is the partnership. Cf. *Campbell v. United States*, 813 F.2d 694, 695-696 (5th Cir. 1987).

officer of Serv-Tech, the general partner of Partnership. Third, petitioner maintains that there was a "realistic prospect" Partnership would have engaged in a trade or business if the "merger" had not taken place because Richard Krajicek and Mr. Randall, the two limited partners with the greatest ownership interests, had the ability to do so given their respective backgrounds as inventor and investment banker.

Respondent contends that Partnership had no realistic prospect of engaging in a trade or business relating to the Fast Clean System but could at most act as a passive investor because of the existence of the exclusive license option. Additionally, respondent argues that activities of Serv-Tech after June 1986 should not be attributed to Partnership because the limited partners' interests in Partnership were much greater than their stockholdings in Serv-Tech after the 1986 exchange. Respondent also maintains that petitioner has not shown that Richard Krajicek was acting on behalf of Partnership in 1985 and 1986.

We agree with respondent.

In order to be entitled to deductions for research and development expenditures, a taxpayer need not be engaged in a trade or business currently. *Snow v. Commissioner*, 416 U.S. 500, 503-504 (1974). However:

> For section 174 to apply, the taxpayer must still be engaged in a trade or business *at some time*, and we must still determine, through an examination of the facts of each case, whether the taxpayer's activities in connection with a product are sufficiently substantial and regular to constitute a trade or business * * * [*Green v. Commissioner*, 83 T.C. 667, 686-687 (1984).]

The applicable test is whether the taxpayer has a "realistic

prospect" of engaging in a trade or business. *Harris v. Commissioner*, 16 F.3d 75, 81 (5th Cir. 1994), affg. T.C. Memo. 1990-80, supplemented by 99 T.C. 121 (1992); *Diamond v. Commissioner*, 92 T.C. 423, 439 (1989), affd. 930 F.2d 372 (4th Cir. 1991); *Spellman v. Commissioner*, 845 F.2d 148, 149 (7th Cir. 1988), affg. T.C. Memo. 1986-403. The factors considered are (1) the terms of the parties' contractual arrangements, (2) the intentions of the parties to the agreements, (3) business activities, if any, of the partnership, (4) exercise of control by the partnership over the entity doing the research, and (5) the capacity and incentive, if any, of the partnership to use the product in its own trade or business. See *Kantor v. Commissioner*, 998 F.2d 1514 (9th Cir. 1993), affg. this issue T.C. Memo, 1990-380; *Double Bar Chain Co. v. Commissioner*, T.C. Memo. 1991-572.

The grant of an exclusive license to exploit technology before beginning research and development has been held to preclude a licensor from engaging in a trade or business with respect to the technology. *Spellman v. Commissioner*, *supra*; *Green v. Commissioner*, *supra*.

We concluded similarly as to an option to acquire an exclusive license to exploit the product granted before the beginning of the research and development work and sale of limited partnership interests in *Diamond v. Commissioner*, *supra*. In *Diamond v. Commissioner*, supra, the taxpayer contended that there was merely an option to acquire an exclusive license, and, if the option was not exercised, the partnership could exploit the products resulting from the research. We concluded that there was no realistic prospect

that the partnership could do so.[12] *Diamond v. Commissioner*, *supra* at 439. In so concluding, we adopted the rationale of the Court of Appeals for the Seventh Circuit in *Spellman v. Commissioner*, 845 F.2d 148 (7th Cir. 1988), that, if the option price is reasonable and sufficient profits are anticipated to justify incurring the manufacturing and marketing costs, the corporation would exercise the option in its sound business judgment. *Diamond v. Commissioner*, *supra* at 440.

Pursuant to the right of first refusal[13] in the license

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[12]*Diamond v. Commissioner*, 92 T.C. 423 (1989), affd. 930 F.2d 372 (4th Cir. 1991), has been repeatedly followed in other situations involving grants of options to acquire exclusive licenses in exchange for royalties, see, e.g., *Harris v. Commissioner*, 16 F.3d 75, 81 (5th Cir. 1994), affg. T.C. Memo 1990-80, supplemented by 99 T.C. 121 (1992); *Kantor v. Commissioner*, 998 F.2d 1514 (9th Cir. 1993), affg. this issue T.C. Memo. 1990-380. We have also disallowed deductions claimed for research and development expenditures in situations where the licenses were not executed in writing contemporaneously with the research and development agreements. See *Stauber v. Commissioner*, T.C. Memo. 1992-128 (facts indicated that a "pre-existing understanding" concerning a future license existed); *Double Bar Chain Co. v. Commissioner*, T.C. Memo. 1991-572 (there existed an "understanding" regarding a future license of technology).

[13]Petitioner does not contend that the right of first refusal (i.e., that Partnership has to "sell, alienate, assign or otherwise transfer any right, title, interest or license" to the Fast Clean System before the licensee can exercise the option) distinguishes this case from *Diamond v. Commissioner*, *supra*. Petitioner did not cite us to any case involving a right of first refusal in this context. The only case found is *Universal Research & Development Partnership No. 1 v. Commissioner*, T.C. Memo. 1991-437, in which the deduction for research and development expenses was allowed. In *Universal Research*, respondent had the burden of persuasion, and the licensee had no more experience relating to the product resulting from the research than the partnership. Here, petitioner bears the burden, and the licensee, the general partner of Partnership, had

option agreement here, Partnership could not sell, alienate, assign, or otherwise transfer any right, title, interest, or license to the Fast Clean System, without offering Serv-Tech the option to an exclusive license to manufacture, use, market, and otherwise commercially exploit the Fast Clean System. The exclusive license option lasted for the life of the patents. In return, Partnership would receive royalties.

During the years 1983 through 1986, Partnership had no employees. See *Harris v. Commissioner*, *supra* at 80 n.10. By contrast, Serv-Tech had established itself in the relevant field and had products related and complementary to the Fast Clean System.

There was marketing activity and some income in 1985 relating to the Fast Clean System. Petitioner has not presented evidence that there was no income earned during the first half of 1986, when royalties would be payable to Partnership under the January 2, 1986, temporary, nonexclusive license agreement, or that royalties were paid. The record does not contain statements from Serv-Tech to Partnership setting forth why royalties were not payable or Serv-Tech's activities on behalf of Partnership during the first half of 1986.[14]

The 1983 memorandum states that: "[Serv-Tech] will acquire * * * [the Fast Clean System], once developed, instead of the Partnership retaining it for use in its own trade or business". See *Double Bar Chain Co. v. Commissioner*,

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extensive experience in the industry.

[14]We consider these facts in deciding whether subsequent events are consistent with our conclusions regarding the prospects in 1983 and 1985 of Partnership's engaging in a trade or business relating to the Fast Clean System. See *Levin v. Commissioner*, 832 F.2d 403, 406 n.3 (7th Cir. 1987), affg. 87 T.C. 698 (1986).

T.C. Memo. 1991-572, in which we considered statements in the private offering memorandum in concluding that the partnership there never intended to engage in a trade or business. The 1986 memorandum states that "It is unlikely that * * * [Partnership] could economically provide for its own account, the experienced personnel, facilities and other resources which will be necessary to market and continue development of the Fast Clean System." Again, this statement in the 1986 memorandum supports our conclusions regarding the prospects in 1983 and 1985 of Partnership engaging in a trade or business relating to the Fast Clean System. See *Levin v. Commissioner*, *supra* at 406 n.3.

We have considered that Richard Krajicek, who was the co-inventor, was a limited partner in Partnership with a 29.7 percent ownership interest. However, he was also the largest single shareholder, president, and chairman of the board of directors of Serv-Tech. We are unable to conclude that, as a limited partner, he was acting on behalf of Partnership.

Recently in concluding that a limited partner was not entitled to deduct research and development expenditures by a partnership which granted an option for a perpetual license of the resulting technology to the corporation doing the research, the Court of Appeals for the Fifth Circuit noted that:

> In analyzing the operational nexus facet of section 174, the courts have dealt with a broad spectrum of financial arrangements. At one end of the spectrum lie arrangements in which a partnership buys stock in a corporation, which then uses the capital to fund research activities, manages the research activities itself, manufactures the resulting product, sells the product in the marketplace, and returns a portion of

> the profits to the partnership as dividends. In these situations, the partnership does not incur research expenses in connection with its trade or business but, instead, functions as an investment vehicle that cannot deduct the cash paid to the corporation under section 174 even if the corporation used that very cash to fund its research expenditures. At the other end of the spectrum lie financial arrangements in which a partnership uses its own funds to conduct research activities, manufactures the product itself, and sells that product in the marketplace. In this instance, the partnership incurs research and development expenditures in connection with its trade or business and deduct them under section 174. * * * [*Harris v. Commissioner*, 16 F.3d 75, 78 (5th Cir. 1994).]

The facts here place Partnership on the "spectrum" as a passive investor used as a financing vehicle, without an established realistic prospect of engaging in a trade or business relating to the Fast Clean System. The expectations were that Serv-Tech would do so, or if Serv-Tech could not do so, an entity other than Partnership would do so. See *United Fibertech, Ltd. v. Commissioner*, T.C. Memo. 1991-445, affd. 976 F.2d 445 (8th Cir. 1992), in which we concluded that, even after the licensee, a research and development corporation, could not market the product because of financial problems, the partnership searched for a successor, and did not try to acquire a staff or "entertain the idea of manufacturing or marketing the product" itself.

Relying on *Snow v. Commissioner*, 416 U.S. 500 (1974), petitioner contends that the activities of Serv-Tech after the exchange of its stock for the limited partners' interests in Partnership should be attributed to Partnership. In *Harris v. Commissioner*, 16 F.3d at 78, the Court of Appeals for the Fifth Circuit stated that:

> *Snow* settled that the temporal nexus of a research project to the start of an active trade or business was not dispositive of section 174's applicability, it left open the degree of "connection" required between the expenditures and the operation of the trade or business itself--the operational nexus * * *

Petitioner has not established "the operational nexus" for Partnership here nor persuaded us that the facts here are sufficiently analogous to *Snow*.

Petitioner argues further that (1) Partnership could only act through its partners, and (2) Richard Krajicek, as a limited partner and an officer of Serv-Tech, the general partner, of Partnership, was doing significant marketing from 1983 through 1986, which should be attributed to Partnership. Petitioner also maintains that advertising brochures of Serv-Tech for services relating to the Fast Clean System should be attributed to Partnership because Serv-Tech was acting on Partnership's behalf.[15] Richard Krajicek testified as follows regarding his activities:

> Q When you were marketing Fast Clean, who were you marketing on behalf of? Let's take first in 1985.

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[15]The testing agreement provisions suggest that Serv-Tech was acting for its own benefit in 1985 and had total control over Partnership. Despite earning revenues from the use of the Fast Clean System, Serv-Tech was not required to make any payment, and apparently not even required to provide an accounting, to Partnership. The testing agreement did not provide for sales of units of the Fast Clean System. Consent to the sales of the units by Serv-Tech in 1985 was not sought or obtained until 1986, nor was an accounting of prices and associated expenses provided.

> A Oh, I guess I was probably marketing on behalf of myself, you know, being I had -- but I would say I was marketing it on behalf of Mach-Tech and the general partners [sic], the people who put up the money.

Both Richard Krajicek and Serv-Tech had many roles in the entities and transactions relating to the Fast Clean System. Petitioner has not persuaded us that either was clearly acting for Partnership in engaging in the marketing activities in 1985. The facts described above indicate that all intended for Serv-Tech to engage in the trade or business as to the Fast Clean System. The party on whose behalf the marketing activities were undertaken was left at best vague[16] so that Serv-Tech could do so. Because the activities of Serv-Tech and Partnership were so intertwined, we cannot conclude that Serv-Tech was acting in its capacity as general partner rather than on its own behalf.

Petitioner also maintains that Partnership had the realistic prospect of engaging in a trade or business relating to the Fast Clean System because, based on their respective experience, Richard Krajicek and Mr. Randall could have marketed the Fast Clean System if the limited partners had not agreed to the "merger" with Serv-Tech. In the reply brief, petitioner argues that Serv-Tech was "near bankruptcy", could not "cram [the exclusive license option]

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[16]Petitioner presented testimony that "typical" marketing efforts for limited partnerships owning real estate and video rental franchises, respectively, are made under the name of entities other than the partnerships. Petitioner relies on the testimony in support of its arguments. We do not find the testimony or these arguments persuasive. The businesses are totally different from that of Partnership, section 174 does not appear to apply, and there is no indication that the courts have concluded the other partnerships engage in a trade or business for tax purposes.

down . . . on" the limited partners, and never intended to exercise it. Additionally in the reply brief, petitioner contends that Mr. Randall would have stopped the exercise of the exclusive license option by Serv-Tech and marketed the Fast Clean System elsewhere.

We rejected a similar argument in *Diamond v. Commissioner*, 92 T.C. 423, 441 (1989), affd. 930 F.2d 372 (4th Cir. 1991), stating as follows:

> Robotics' general partners had an abundance of relevant experience, which they could presumably employ to assemble a staff. However, the Seventh Circuit found in *Spellman* that the lack of such resources was not the factor that was fatal to the taxpayer's case, but that "whatever Sci-Med's desires," it would have the opportunity to engage in a trade or business with respect to the byproducts only if it was uneconomical to do so [and the option was not exercised]. Taxpayer there, as petitioner here, is prevented from engaging in the particular trade or business either by the law of contracts or the laws of economics.

Petitioner has not demonstrated that Serv-Tech would not exercise the option under its right of first refusal, how it could be stopped from doing so, or why the option existed if Serv-Tech did not intend to exercise it. Petitioner has not sufficiently shown that Serv-Tech was "near bankruptcy" (the limited partners who exchanged their interests in Partnership for Serv-Tech stock apparently did not think so), or that there was a realistic prospect that Partnership would engage in a trade or business even if Serv-Tech did not exercise the option or otherwise acquire rights to the Fast Clean System.

Petitioner relies on testimony of Mr. Randall in response to a hypothetical question assuming that the limited partners rejected the exchange of Serv-Tech stock for their partnership interests as follows:

> Q * * *
>
> My question to you is, sir, at that time if Serv-Tech had come back to you and said, Well, we are now going to exercise our permanent royalty, and take the technology from you, what would have been your reaction?
>
> * * * * * * *
>
> THE WITNESS: I would have seriously objected and sought remedies to stop that.
>
> * * * * * * *
>
> Q And why is that, sir?
>
> A Well, if I had said no to the Serv-Tech offer, after it was improved, it would have been because I lacked confidence in the future of the company. And I would have wanted to take the product that we had developed and market it elsewhere. And marketing such a thing like that is something that I was familiar with.

However, on cross-examination, Mr. Randall testified that this reference to marketing the Fast Clean System assumed that Mr. Krajicek would also be involved in that effort and was, at best, vague as to whether he would have gone forward without Mr. Krajicek. This testimony does not persuade us that Mr. Randall could have stopped Serv-Tech from exercising the option or had a realistic plan for

Partnership to engage in a trade or business, rather than to license the Fast Clean System for royalties.

Although petitioner implies in the reply brief that testimony of the vice president, chief financial officer, and a director of Serv-Tech as of January 1986 was to the effect that Serv-Tech would never exercise the exclusive license option, the testimony does not say this clearly and is insufficient to establish this point.

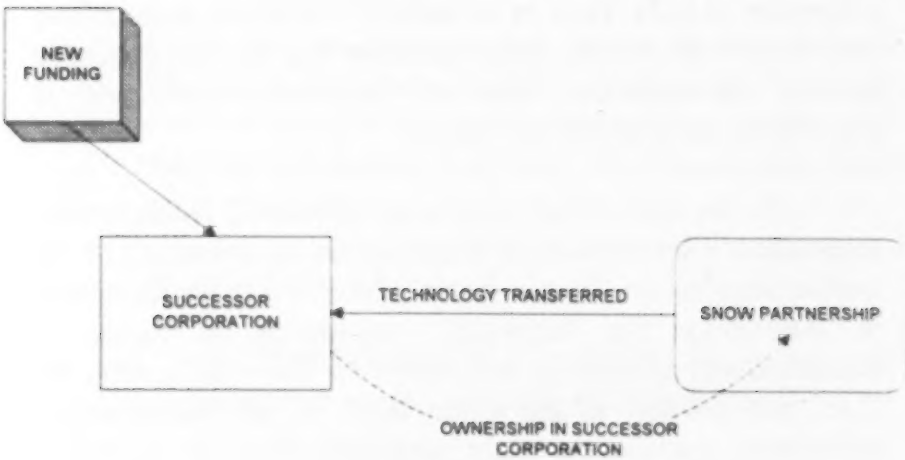
In the reply brief, petitioner repeatedly characterizes respondent's contentions as based not on the substance of the transactions but on "magic words", referring to the term used in describing the taxpayers' arguments in *Levin v. Commissioner*, 832 F.2d 403, 406 (7th Cir. 1987), affg. 87 T.C. 698 (1986), to the effect that: "if the partnership's documents contain the right language, then all is well." Unfortunately, this characterization does not do the trick, because neither the form (the documents) nor the substance of the transaction supports petitioner's position.

To reflect the foregoing,

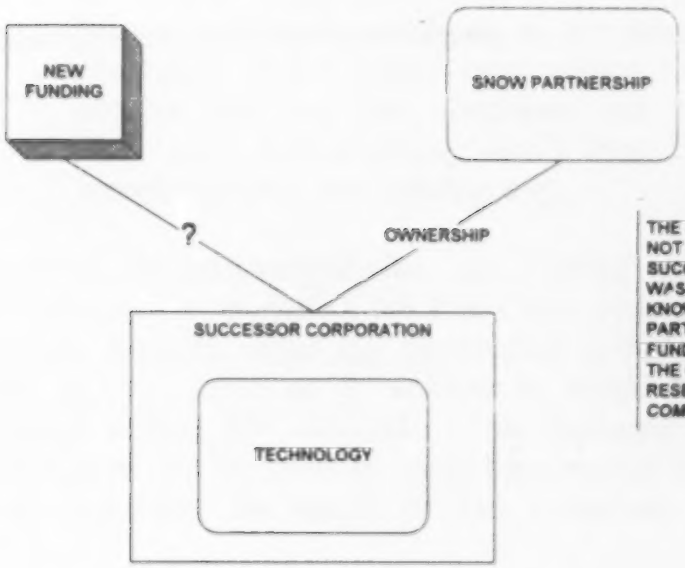
Decision will be entered for respondent.

APPENDIX C-1

DIAGRAM OF TRANSFER OF TECHNOLOGY IN *SNOW V COMMISSIONER*



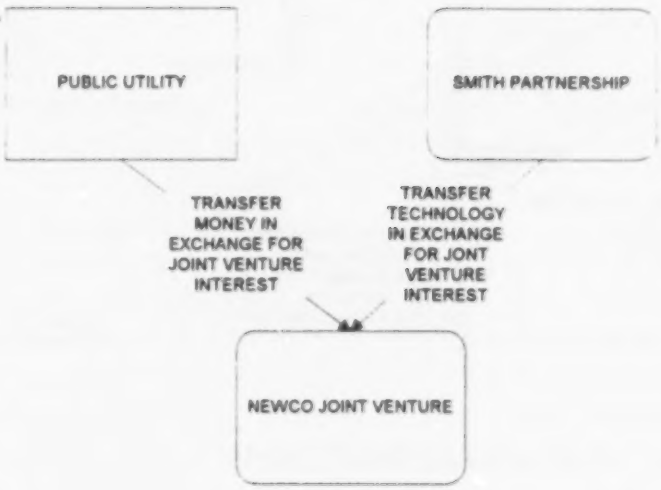
POST TRANSFER OWNERSHIP



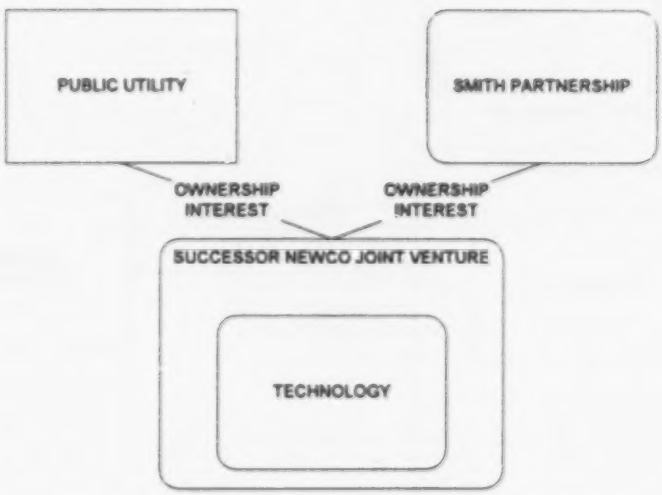
THE *SNOW* RECORD DOES NOT DISCLOSE HOW THE SUCCESSOR CORPORATION WAS OWNED. ALL THAT IS KNOWN IS THAT THE SNOW PARTNERSHIP HAD NO FUNDS REMAINING AFTER THE COMPLETION OF THE RESEARCH. SEE, *SNOW V COMMISSIONER*, 58 T.C. at 591

APPENDIX C-2

DIAGRAM OF TRANSFER OF TECHNOLOGY IN *SMITH V COMMISSIONER*

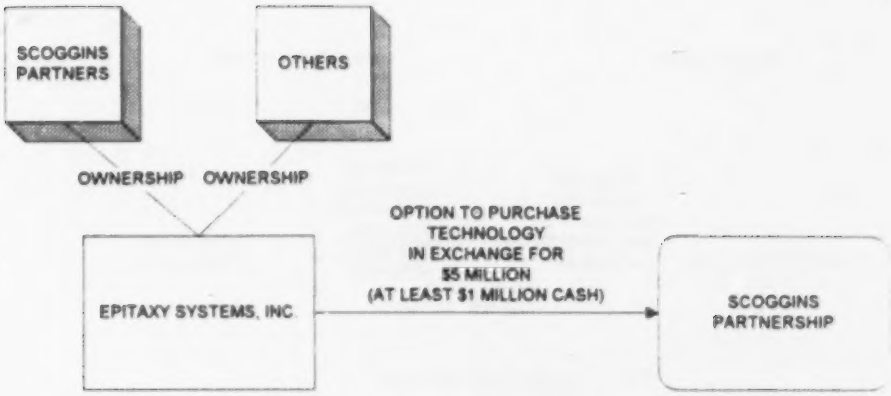

PUBLIC UTILITY
SMITH PARTNERSHIP
TRANSFER MONEY IN EXCHANGE FOR JOINT VENTURE INTEREST
TRANSFER TECHNOLOGY IN EXCHANGE FOR JONT VENTURE INTEREST
NEWCO JOINT VENTURE

POST TRANSFER OWNERSHIP

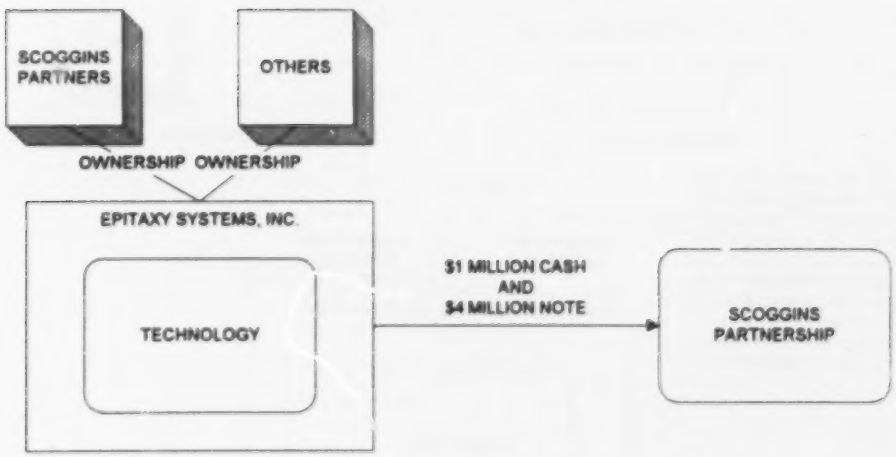


APPENDIX C-3

DIAGRAM OF TRANSFER OF TECHNOLOGY IN *SCOGGINS V COMMISSIONER*

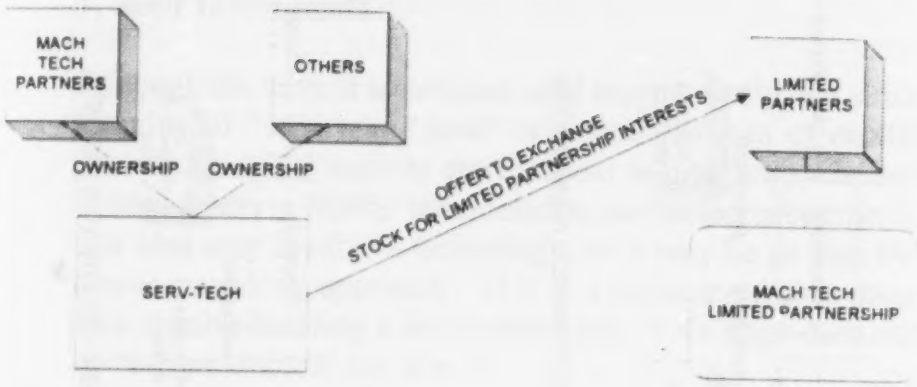


POST TRANSFER OWNERSHIP
(ASSUMING EXERCISE OF OPTION)

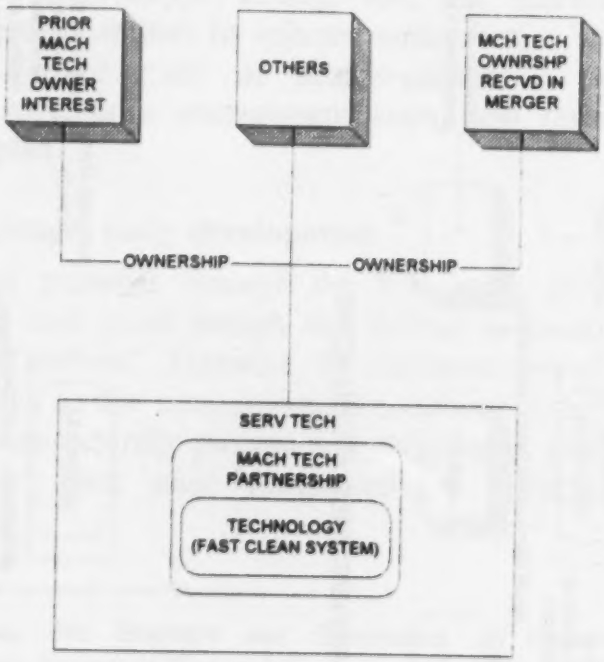


APPENDIX C-4

DIAGRAM OF TRANSFER OF TECHNOLOGY IN *MACH-TECH V COMMISSIONER*

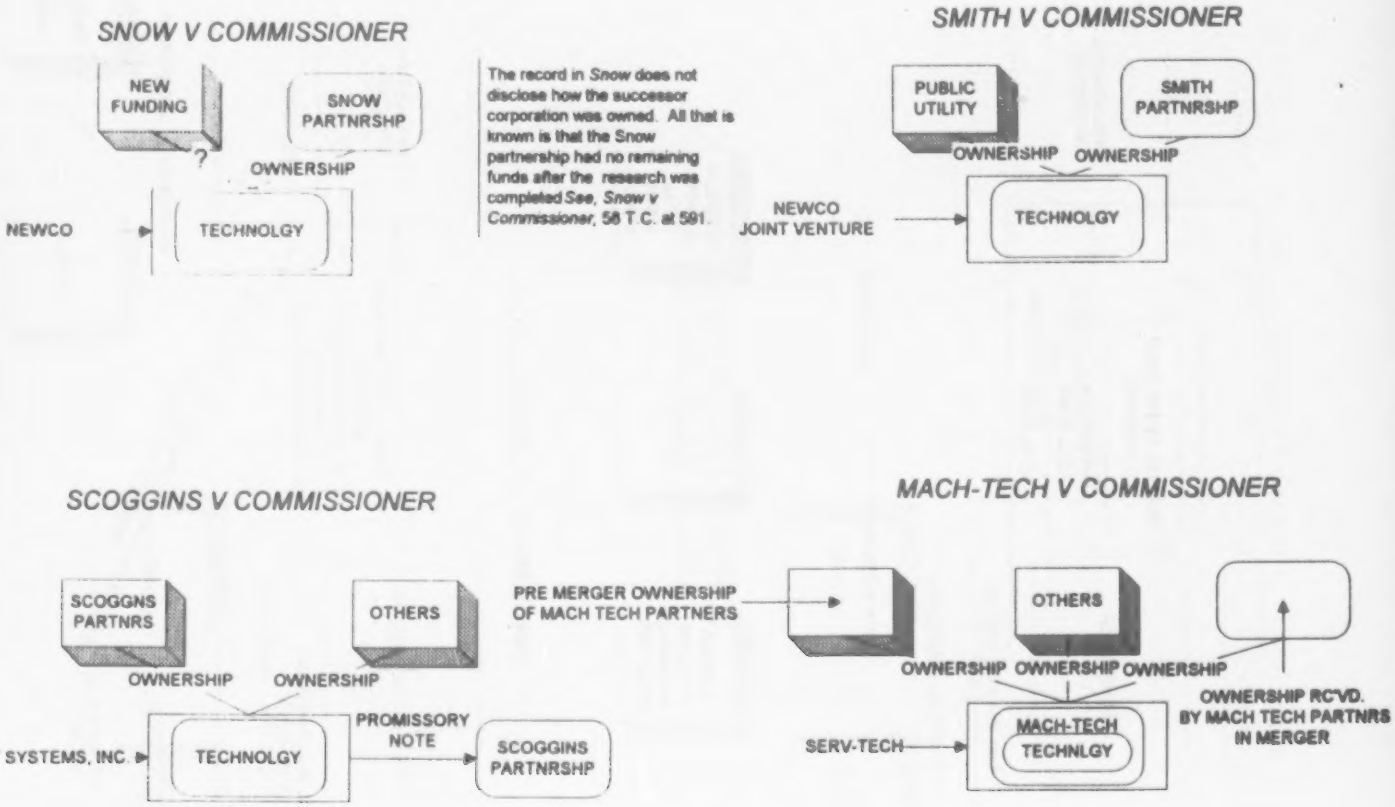


POST TRANSFER OWNERSHIP



APPENDIX C-5

SINGLE DIAGRAM DEPICTING POST TECHNOLOGY TRANSFER OWNERSHIP IN *SNOW, SMITH, SCOGGINS* AND *MACH-TECH*



APPENDIX D

The Stages of Venture-Capital Investing[1]

1. Seed Investments

Although the term is sometimes used more broadly, the strict meaning of "seed investment" is a small amount of capital provided to an inventor or entrepreneur to determine whether an idea deserves further consideration and further investment. The idea may involve a technology, or it may be an idea for a new marketing approach. If it is a technology, this stage may involve building a small prototype. This stage does not involve production for sale.

2. Startup

Startup investments usually go to companies that are less than one year old. The company uses the money for product development, prototype testing, and test marketing (in experimental quantities to selected customers). This stage involves further study of market-penetration potential, bringing together a management team, and refining the business plan.

3. First Stage- early development

Investment proceeds through the first stage only if the prototypes look good enough that further technical risk is considered minimal. Likewise, the market studies must look good enough so that management is comfortable setting up a modest manufacturing process and shipping in commercial quantities. First stage companies are unlikely to be profitable.

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[1]Sahlman, *The Structure and Governance of Venture-Capital* Organizations, Journal of Financial Economics 27 (1990) 473-521, 479

4. Second stage-expansion

A company in the second stage has shipped enough product to enough customers so that it has real feedback from the market. It may not know quantitatively what speed of market penetration will occur later, or what the ultimate penetration will be, but it may know the qualitative factors that will determine the speed and limits of penetration. The company is probably still unprofitable, or only marginally profitable. It probably needs more capital for equipment purchases, inventory and receivable financing.

5. Third Stage-profitable but cash poor

For third stage companies, sales growth is probably fast, and positive profit margins have taken away most of the downside investment risk. But, the rapid expansion requires more working capital than can be generated from internal cash flow. New VC capital may be used for further expansion of manufacturing facilities, expanded marketing, or product enhancement. At this stage, banks may be willing to supply some credit it is can be secured by fixed assets or receivables.

6. Fourth Stage-rapid growth toward liquidity point

Companies at the fourth stage of development may still outside cash to sustain growth, but they are stable enough so that the risk to outside investors is much reduced. The company may prefer to use more debt financing to limit equity dilution. Commercial bank credit can play a more important role. Although the cash-out point for VC investors is thought to be within a couple of years, the form (IPO, acquisition, or LBO) and timing of cash out are still uncertain.

7. Bridge Stage- mezzanine investment

In bridge or mezzanine investment situations, the company may have some idea which form of exit is most likely, and even know the approximate timing, but it still needs more capital to sustain rapid growth in the interim. Depending on how the general stock market is doing, and how the given types of high tech stocks are doing within the stock market, "IPO windows" can open and close in very unpredictable ways. Likewise, the level of interest rates and the availability of commercial credit can influence the timing and feasibility of acquisitions or leveraged buyouts. A bridge financing may also correspond to a limited cash-out of early investors or management, or a restructuring of positions among VC investors.

8. Liquidity stage- cash out or exit

A literal interpretation of "cash-out" would seem to imply trading the VC held shares in a portfolio company for cash. In practice, it has come to mean the point at which the VC investors can gain liquidity for a substantial portion of their holdings in a company. The liquidity may come in the form of an initial public offering. If it does, liquidity is still restricted by the holding periods and other restrictions that are part of SEC Rule 144, or by "stand-off" commitments made to the IPO underwriter, in which the insiders agree not to sell their shares for some period of time after the offering (for example, 90 or 180 days). If the acquisition is the form of cash-out, the liquidity may be in the form of cash, shares in a publicly traded company, or short term debt. If the acquisition if paid for in the shares of a nonpublic company, such shares may be no more liquid than the shares of the original company. Likewise, if the sellers take back debt in a leveraged buyout, they may wind up in a less liquid position than before, depending upon the liquidity features of the debt.